EXTREME DEPARTURE: NOT SO EXTREME IN THE PUBLIC OFFERING CONTEXT

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I. INTRODUCTION

On October 1, 2014, Robby Shawn Stadnick and numerous others purchased shares of Vivint Solar—a solar energy company with a lucrative business model—helping it raise more than $300 million in proceeds.[1] Any reasonable investor would have expected his or her newly purchased shares to, at minimum, hold their value over time, but, ideally, increase in value so as to turn a substantial profit. This, however, was not the case for Stadnick and others who purchased the 20,600,000 shares of Vivint Solar's common stock that first Wednesday in October 2014.[2]

Much thought surrounds the valuation of shares in anticipation of a public offering.[3] So when the price of Vivint Solar's shares quickly dropped by more than 22%,[4] a reasonable investor, such as Stadnick, would have justifiably been upset and concerned. In anticipation of a public offering, a reasonable investor would presumably have read the issuer's prospectus and registration statement, becoming intimately familiar with the issuer's business model and financials, and confirming that the stock valuation was

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1 Second Consolidated Amended Complaint for Violation of the Federal Securities Laws at ¶ 1, Stadnick v. Vivint Solar, Inc., Nos. 14-cv-9283-KBF, 14-cv-9709-KBF (S.D.N.Y. Dec. 10, 2015), 2015 WL 8492757 [hereinafter *Second Amended Complaint*].

2 *Id.*

3 Shayndi Raice, *The Art of the IPO*, WALL ST. J. (Nov. 12, 2012, 6:54 PM), https://www.wsj.com/articles/SB10001424052970203922804578080763596406112 ("It's a fine line. Price your shares too high, and you'll collect a lot of money. But the subsequent drop may alienate investors and demoralize your employees. Price them too low and you'll grab plenty of headlines as your stock soars on takeoff, but you've failed to raise nearly as much as you could have, and the initial buying frenzy may end up costing you some long-term investors.").

4 *Second Amended Complaint*, *supra* note 1.

reasonable and the shares were worth purchasing.[5] Hence, a collective shareholder loss of $60 million is likely to shock an investor like Stadnick.[6]

In the case of Vivint Solar, an investor such as Stadnick may not have predicted such a loss based on a normal reading of the prospectus and registration statement. This is because the loss that Stadnick and other like-investors suffered was the result of a conveniently timed public offering, taking place almost immediately prior to Vivint Solar's release of its third quarter financial statements, which would show a dismal performance far greater than what a number of investors would have forecasted.[7] An outcome of the sort that Stadnick and other Vivint Solar investors experienced begs the court for intervention. Yet, for an issuing entity, it can be difficult to predict when it is necessary to disclose interim financial statements in anticipation of a public offering, as the circuits are split on what the appropriate test for making that determination is: the total mix test[8] or the extreme departure test.[9] This Comment will argue that the correct test courts should apply is the extreme departure test, expressed in *Shaw v. Digital Equipment Corporation*.[10]

Both the total mix test and the extreme departure test are fairly straightforward and can be summarized somewhat simply. The total mix test seeks to determine "whether there is 'a substantial likelihood that the disclosure of the omitted [interim financial statements] would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'"[11] The extreme departure test, on the other hand, asks whether the issuing entity was "in possession of nonpublic information indicating that the quarter in progress at the time of the public offering will be an extreme departure from the range of results which could be anticipated based on currently available information" in determining whether Section 11 liability is warranted due to the omission of interim financial statements within a prospectus, registration statement, etc.[12]

This Comment will examine the peculiar and significant context of a public offering in determining whether courts considering Section 11

[5] For an analysis on the reasonable investor and what is normally expected of him or her, see Tom C.W. Lin, *Reasonable Investor(s)*, 95 B.U. L. REV. 461 (2015).

[6] *Second Amended Complaint*, *supra* note 1.

[7] *Id.*

[8] The total mix test is commonly known as the materiality test. Stadnick v. Vivint Solar, Inc., 861 F.3d 31, 36 (2d Cir. 2017).

[9] *Compare id.* (applying the total mix test), *with* Shaw v. Dig. Equip. Corp., 82 F.3d 1194 (1st Cir. 1996) (applying the extreme departure test).

[10] *Shaw*, 82 F.3d at 1210.

[11] *Stadnick*, 861 F.3d at 37 (quoting DeMaria v. Andersen, 318 F.3d 170, 180 (2d Cir. 2003)).

[12] *Shaw*, 82 F.3d at 1210; 15 U.S.C. § 77k (2018).

liability should apply the total mix test or the extreme departure test for determining the materiality of omitting interim financial statements. Part II of this Comment will provide the necessary background concerning Section 11 of the Securities Act of 1933.[13] Part III will present an overview of *Stadnick v. Vivint Solar, Inc.* and *Shaw v. Digital Equipment Corporation*, and the two different materiality tests that were applied, creating a circuit split (the "Circuit Split"). Part III will also argue that the extreme departure test should be the applicable test for determining materiality for purposes of Section 11 liability. Part IV will examine the policy implications underlying both tests. Part V will argue that, moving forward, circuits should apply the extreme departure test because it (1) best accommodates the expectations of actual, rather than reasonable, investors; (2) best fits with the existence of the insider trading disclose or abstain rule; and (3) best reconciles the need for a fiduciary duty in the context of insider trading with the nonexistence of such in a public offering. Part V will also examine the remaining issues to be resolved in implementing the extreme departure test and concludes that the better test for circuits to apply remains the extreme departure test.

II. INTRA-QUARTERLY DISCLOSURES, SECTION 11, AND THE SECURITIES ACT OF 1933: WHEN IS DISCLOSURE REQUIRED?

Congress enacted the Securities Act of 1933 ("'33 Act"), which governs the initial offering of securities, with the primary objectives of (1) ensuring that potential investors receive significant information—financially and otherwise relevant—regarding the securities to be sold in a public offering; and (2) eliminating all forms of fraud, deceit, and misrepresentation in connection with such offerings.[14] To these ends, the '33 Act requires issuing entities to register their securities with the Securities and Exchange Commission (SEC), and also generally requires an issuer to disclose a description of its properties and business, the security to be offered, information concerning its management structure, and independently certified financial statements.[15] As such, the registration requirement seeks to efficiently provide potential investors with a complete and accurate impression of the security to be offered.[16]

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13 15 U.S.C. § 77k.

14 *The Laws that Govern the Securities Industry*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/answers/about-lawsshtml.html (last visited Apr. 19, 2018) (explaining that the '33 Act, "[o]ften referred to as the 'truth in securities' law . . . has two basic objectives: [to] require that investors receive financial and other significant information concerning securities being offered for public sale; and [to] prohibit deceit, misrepresentations, and other fraud in the sale of securities").

15 *Id.*

16 *Id.*

Significantly, however, the SEC does not guarantee that the information that issuing entities provide in their registration statements is, in fact, accurate.[17] Instead, the '33 Act provides investors with a private action to enforce Section 11 for material misrepresentations and omissions in the registration statement, among other things.[18]

Under Section 11 of the '33 Act, issuing entities have a duty to disclose material information to potential investors in anticipation of a public offering.[19] And they may be liable for registration statements containing "an untrue statement of a material fact or omit[ting] to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[20] An investor who bought shares—either at the time of a public offering, or on a secondary market and thereafter traceable to the public offering—may bring a civil suit against the issuing entity for violating Section 11 where that issuer omitted statements that would have been otherwise necessary to make the registration statement complete and not materially misleading.[21]

Inherent in the federal securities laws, however, is the notion that silence on the part of an issuing entity cannot be actionable when the issuer has no duty to disclose.[22] Significant to the issue analyzed herein is the fact that "the mere possession of material nonpublic information does not create a duty to disclose it."[23] The context of a public offering, however, creates "a strong affirmative duty of disclosure" on the part of the issuer,[24] generating some confusion for an issuer regarding what exactly its obligations are.

Issuing entities can turn to case law for some guidance as to the types of information that must be disclosed.[25] As previously mentioned, though, silence where there is no duty to disclose is not actionable.[26] But if an issuing entity does choose to disclose information though it has no legal duty to do so, the disclosure must be truthful and non-misleading.[27]

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[17] *Id.*
[18] *See id. See also* 15 U.S.C. § 77k.
[19] *See generally* 15 U.S.C. § 77k.
[20] *Id.*
[21] *Securities Act of 1933*, LEGAL INFO. INST., https://www.law.cornell.edu/wex/securities_act_of_1933 (last visited Feb. 19, 2019) [hereinafter LEGAL INFORMATION INSTITUTE].
[22] Shaw v. Dig. Equip. Corp., 82 F.3d 1194, 1202 (1st Cir. 1996).
[23] *Id.* (citing Roeder v. Alpha Indus., Inc., 814 F.2d 22, 26 (1st Cir. 1987)).
[24] *Id.* (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976)).
[25] *See* J & R Mktg., SEP v. Gen. Motors Corp., 549 F.3d 384, 398 (6th Cir. 2008) (citing 15 U.S.C. §§ 77k(a), 77l(a)(2) (2018)); Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988); Mayer v. Mylod, 988 F.2d 635, 639 (6th Cir. 1993).
[26] *Id.*
[27] *Id.*

Section 11 liability often arises out of an issuing entity's failure to disclose information required under Items 303 or 503 of Regulation S-K[28]: Item 303 requires issuing entities to provide forward-looking projections concerning any information that they possess;[29] and Item 503 requires issuing entities to disclose the most significant factors that potentially render the offering risky.[30]

Under Item 303, an issuer must disclose any information "that significantly or materially decreases the predictive value of [its] reported results."[31] An issuing entity's internal forecasts are not considered to be material information giving rise to a duty to disclose.[32] Such disclosure is not required because of the SEC's apprehension that investors may misinterpret such information.[33]

There are certain events, courts have noted, that would require an issuing entity to provide intra-quarter updates, however.[34] "[M]aterial forward-looking information regarding known material trends and uncertainties [must] be disclosed as part of the required discussion of those matters and the analysis of their effects."[35] Courts consider statements or omissions material where a reasonable investor would have considered such information in making a significant investment decision.[36] The exact test for materiality, as has been presented and will further be discussed in Part III, differs amongst circuits.[37] A duty to disclose, however, arises when an

28 BRENT A. OLSON, PUBLICLY TRADED CORPORATIONS HANDBOOK §5:101 (2d ed. 2017).

29 *J & R Mktg., SEP*, 549 F.3d at 392 (citing 17 C.F.R. § 229.303(a)(1), (2)(ii), (3)(ii) (2018)).

30 City of Roseville Emps.' Ret. Sys. v. EnergySolutions, Inc., 814 F. Supp. 2d 395, 426 (S.D.N.Y. 2011) (quoting 17 C.F.R. § 229.503(c) (2018)).

31 Oxford Asset Mgmt., Ltd. v. Jaharis, 297 F.3d 1182, 1192 (11th Cir. 2002); *see also* Slater v. A.G. Edwards & Sons, Inc., 719 F.3d 1190, 1197–1203 (10th Cir. 2013).

32 *In re* Facebook, Inc. IPO Sec. & Derivative Litig., 986 F. Supp. 2d 487, 506–07 (S.D.N.Y. 2013); *see also* Glassman v. Computervision Corp., 90 F.3d 617, 631 (1st Cir. 1996) ("Plaintiffs' nondisclosure claims fail because they base their allegations solely on discrepancies between actual (but undisclosed) intra-quarterly information and [the issuing entity's] undisclosed internal projections."); Steckman v. Hart Brewing, Inc., No. 96-1077-K, 1996 WL 881659, at *4 (S.D. Cal. Dec. 24, 1996) ("[Issuing entities] have no duty to disclose intraquarter results, even if those results are lower than the company's internal projections.").

33 *In re Facebook*, 986 F. Supp. 2d at 507 (citing *In re* Ivan F. Boesky Sec. Litig., 825 F. Supp. 623, 635 (S.D.N.Y. 1993).

34 *Id.* at 513 (citing *In re* Bank of Am. Sec. Corp. Derivative & ERISA Litig., 757 F. Supp. 2d 260, 304 (S.D.N.Y. 2010); Milman v. Box Hill Sys. Corp., 72 F. Supp. 2d 220, 231 (S.D.N.Y. 1999)).

35 Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 33–8350, 68 Fed. Reg. 75,062 (Dec. 29, 2003), https://www.sec.gov/rules/interp/33-8350.htm.

36 *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 232–33 (1988); Ganino v. Citizens Util. Co., 228 F.3d 154, 161–62 (2d Cir. 2000).

37 *Compare* Stadnick v. Vivint Solar, Inc., 861 F.3d 31 (2d Cir. 2017), *with* Shaw v. Dig.

issuing entity's financial predictions based on interim financial data "cease to be optional forecasts and instead become present knowledge."[38] Thus, the issue that interim financial statements pose to the inquiry discussed herein lies in the determination of whether they contain "material forward-looking information regarding known material trends or uncertainties."[39]

III. THE CIRCUIT SPLIT

This Part provides an overview of *Stadnick v. Vivint Solar, Inc.* and *Shaw v. Digital Equipment Corporation*, including the respective courts' analysis of the relevant issues, including which test is to be applied in determining whether to invoke Section 11 liability. To reiterate, the two tests may be summarized as follows: the total mix test looks at the information that a prospective investor had at hand in the wake of the public offering to determine whether the quarter-end results of the issuing entity would have been predictable by a reasonable investor given what information was made available to them;[40] and the extreme departure test looks at the information that the issuing entity had at hand for the quarter in which the public offering took place, and seeks to determine whether that information would have indicated that the quarterly results would have been an extreme departure from prior predictions.[41]

In light of the preceding discussion of the '33 Act and, particularly, Section 11 liability, it is relevant to turn once again to the narrative that opened this Comment. As mentioned earlier, issuing entities consider many options in valuing their impending stock issuance,[42] including the timing of the public offering.[43]

Equip. Corp., 82 F.3d 1194 (1st Cir. 1996).

38 Steckman v. Hart Brewing, Inc., 143 F.3d 1293, 1297 (9th Cir. 1998); *see also* Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 6711, 52 Fed. Reg. 13715, 13717 (Apr. 24, 1987) ("Both required disclosure regarding the future impact of presently known trends, events or uncertainties and optional forward-looking information may involve some prediction or projection. The distinction between the two rests with the nature of the prediction required. Required disclosure is based on currently known trends, events, and uncertainties that are reasonably expected to have material effects, such as: A reduction in the registrant's product prices; erosion in the registrant's market share; changes in insurance coverage; or the likely non-renewal of a material contract. In contrast, optional forward-looking disclosure involves anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty.").

39 *In re* Facebook, Inc. IPO Sec. & Derivative Litig., 986 F. Supp. 2d 487, 508 (S.D.N.Y. 2013) (citation omitted).

40 *Stadnick*, 861 F.3d at 37.

41 *Shaw*, 82 F.3d at 1210.

42 *See* Raice, *supra* note 3.

43 For an overview of the factors and conditions that issuing entities take into account when determining when to publicly offer shares, see Simon Benninga et al., *The Timing of*

While most public offerings are strategically timed,[44] the timing of Vivint Solar's public offering was particularly deceptive. Vivint Solar's public offering took place on October 1, 2014, just one day after the end of its third quarter.[45] As such, the quarter-end financial projections would have presumably been fairly concrete and only slightly speculative.[46] On November 10, 2014, forty days after its public offering, Vivint Solar released its financial results for the third quarter: a decrease in the company's net loss by $28.6 million.[47] This information had not been provided to the potential investors prior to the public offering.[48] Vivint Solar's stock thereafter lost value; shares that had been sold at $16 per share at the public offering dropped to $11.70 per share just forty-three days later.[49]

A similar situation occurred twenty-one years earlier when investors purchased the debt and equity securities of Digital Equipment Corporation.[50] In that case, Digital Equipment Corporation scheduled its public offering to begin just eleven days before the end of its third quarter and to close four days before the end of its third quarter.[51] Just three weeks later, Digital Equipment Corporation released its financial statements for the third quarter, demonstrating its largest loss in over seven fiscal quarters.[52] On that same day, its common stock value fell from $28.875 to $21.125.[53]

While the course of events in *Stadnick v. Vivint Solar, Inc.* and in *Shaw v. Digital Equipment Corporation* were uncannily similar, the courts in the two jurisdictions applied different tests to determine whether the respective quarter-to-date financial information were material, and thus their omission from the registration statement actionable.[54] The Second Circuit in *Stadnick* split with the First Circuit in *Shaw* on the issue of whether a failure to disclose interim financial statements may be a material omission giving rise

Initial Public Offerings, 75 J. FIN. ECON. 115 (2005) (analyzing "the optimal conditions for taking a company public").

44 Tom Farley, *The Right Time to IPO*, NYSE, https://www.nyse.com/article/right-time-to-ipo (last visited Feb. 2, 2019).

45 *Stadnick*, 861 F.3d at 34.

46 *See Second Amended Complaint*, *supra* note 1.

47 *Stadnick*, 861 F.3d at 34.

48 *Id.*

49 *Id.* at 34–35.

50 Shaw v. Dig. Equip. Corp., 82 F.3d 1194 (1st Cir. 1996).

51 *Id.* at 1200.

52 *Id.* ("[O]n April 15, 1994, [Digital Equipment Corporation] announced an operating loss of over $183 million for the quarter that had ended on April 2, 1994. This third quarter loss was far greater than analysts had been expecting, and the largest that the company had reported since the first quarter of fiscal 1993.").

53 *Id.*

54 *Compare Stadnick*, 861 F.3d 31 (applying the total mix test), *with Shaw*, 82 F.3d 1194 (applying the extreme departure test).

to Section 11 liability.[55]

A. *Shaw v. Digital Equipment Corp.*

1. Factual Background

Shaw v. Digital Equipment Corporation involved an action brought by preferred and common shareholders against Digital Equipment Corporation, its Chief Executive Officer (CEO), Chief Financial Officer (CFO), and seven underwriting and investment banking firms.[56] The plaintiffs sued the defendants under Sections 11 and 12(2) of the '33 Act.[57] With respect to their Section 11 claims,[58] plaintiffs asserted that Digital Equipment Corporation's management was aware and in possession of material facts relating to large-scale losses to be reported in its third quarter of fiscal year 1994, which the plaintiffs argued created a duty to disclose in connection with the public offering.[59] Defendants responded by equating plaintiffs' argument to an assertion that the issuer was required to release internal forecasts concerning the third quarter, and argued that such a claim was "untenable because the securities laws impose no duty upon a[n] [issuing entity] to disclose internal projections, estimates of quarterly results, or other forward-looking information."[60]

At the time, Digital Equipment Corporation was one of the largest computer hardware, software, and services suppliers in the world.[61] Having gone public in 1966, by the early 1990's it was earning roughly $14 billion per year in revenue.[62] In 1992, however, Digital Equipment Corporation suffered quarterly losses of $138.3 million in January alone and between $30–311 million in the succeeding months.[63] The company underwent a massive overhaul of its operating and management structure, cutting 35,000 jobs and replacing its CEO,[64] and, as a result, incurred restructuring charges of approximately $3.2 billion for the years 1990–1992.[65] Notably, the company introduced a new, revolutionary product that jumpstarted its

55 B. Colby Hamilton, *Second Circuit Splits with First Over Securities Disclosure Test*, N.Y.L.J. (June 21, 2017, 3:58 PM), https://www.law.com/newyorklawjournal/almID/1202790829271/.

56 *Shaw*, 82 F.3d at 1201.

57 *Id.*

58 This factual overview and analysis of the court's reasoning is limited to a review of the Section 11 claim only, as that is what is pertinent to the argument made herein.

59 *Shaw*, 82 F.3d at 1201.

60 *Id.* at 1202.

61 *Id.* at 1199.

62 *Id.*

63 *Id.*

64 *Id.*

65 *Shaw*, 82 F.3d at 1199.

financial growth in February 1992.[66] It finally had a profitable quarter in mid-1993, announcing a net profit of $113.2 million.[67] This success was unsustainable, as the company reported a loss of $72 million for the second quarter of 1994.[68]

Digital Equipment Corporation thereafter filed a shelf registration with the SEC, providing the company with the option of issuing a maximum of $1 billion in various debt classes and equity securities.[69] The company began issuing stock on March 21, 1994, and ended its sale on March 28, 1994, four days prior to the end of its third quarter.[70] At an offering price of $25 per share, the sale of the entirety of Digital Equipment Corporation's depositary shares of preferred stock resulted in $387.4 million in proceeds for the company.[71]

Digital Equipment Corporation announced its third quarter earnings less than three weeks after the close of its public offering.[72] The reported loss was far greater than analysts' expectations and was, in fact, its largest reported loss since fiscal year 1993's first quarter.[73] This announcement sent preferred stock prices plummeting from the offering price of $25 per share to $20.875 on April 15, and common stock prices plummeting from a high of $28.875 to $21.125 by the next trading day.[74]

2. The Court's Reasoning

In *Shaw v. Digital Equipment Corporation*, the First Circuit analyzed whether Digital Equipment Corporation was legally obligated to disclose, in the registration statement, the imminent report of third quarter losses to investors.[75] In sum, the First Circuit was uncertain as to the materiality of the information that Digital Equipment Corporation had in its possession at the time of the offering.[76] Rather, it was unable to hold that Digital Equipment Corporation "was not required to disclose material information concerning its" third quarter interim financial statements.[77] Ultimately, the First Circuit chose to apply the extreme departure test to the above-mentioned facts to determine materiality because "it [was] consistent with

[66] *Id.* at 1200.
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *Shaw*, 82 F.3d at 1200.
[72] *Id.*
[73] *Id.*
[74] *Id.*
[75] *Id.* at 1202.
[76] *Id.* at 1203.
[77] *Shaw*, 82 F.3d at 1203.

the basic statutory policies favoring disclosure to require inclusion of that information in the registration statement."[78] These statutory policies will now be discussed.

i. Insider Trading

In its analysis, the First Circuit began by undertaking an insider trading analysis to compare the requirements of disclosure for an individual corporate insider in an insider trading case to the requirements for a corporation on the brink of a public offering.[79] The court "conceptualiz[ed] [Digital Equipment Corporation] (the corporate issuer) as an individual insider transacting in the company's securities, and . . . examine[d] the disclosure obligations that would then arise."[80] The court noted that the "disclose or abstain" rule, frequently applied to insider trading by individuals, is also applicable to an issuing entity trading in its own securities.[81] The court expanded on this notion by positing that a rule comparable to disclose-or-abstain should be applicable to an issuing entity engaged in the public offering of its own shares.[82] Otherwise, the court noted, "a corporate issuer selling its own securities would be left free to exploit its informational trading advantage, at the expense of investors, by delaying disclosure of material nonpublic negative news until after completion of the offering."[83]

ii. Section 11 and SEC Policy

The court then conducted a policy analysis regarding whether strong disclosure requirements, such as those that exist in the context of an individual corporate insider in an insider trading case, should also exist in the context of corporate issuers.[84] The civil liability imposed by Section 11 ensures that issuing entities put forth full and complete effort in preparing their registration statements and ensuring that all required material

[78] *Id.* at 1210.

[79] *Id.* at 1203.

[80] *Id.* The First Circuit provided several justifications for analogizing individual insider trading and corporate insider trading. *Id.* For more information concerning the court's analysis, see LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION, ch. 9, § B.4 (5th ed. 2013) ("When the issuer itself wants to buy or sell its own securities, it has a choice: desist or disclose."); 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION § 3:6 (2018) ("Issuers themselves may buy or sell their own securities, and have long been held to an obligation of full disclosure . . . . Conceptually, extending the insider trading prohibition to instances of issuer insider trading makes perfect sense.").

[81] *Shaw*, 82 F.3d at 1203.

[82] *Id.* at 1204.

[83] *Id.*

[84] *Id.*

information is contained therein.[85] Particular to *Shaw* is the fact that Digital Equipment Corporation prepared its public offering pursuant to SEC Form S-3, which requires that the prospectus describe:

> any and all material changes in the registrant's affairs which have occurred since the end of the latest fiscal year for which certified financial statements were included in the latest annual report to security holders and which have not been described in a report on Form 10-Q or Form 8-K filed under the Exchange Act.[86]

The court noted that the entire point of the requirement of disclosing material changes under Item 11(a) is to ensure that any and all necessary updates to the information were provided to the original SEC filings and the prospectus, even those concerning "'known trends and uncertainties' with respect to 'net sales or revenues or income from continuing operations.'"[87] Given the amount of information and the nature of such information that Digital Equipment Corporation had at hand during the days leading up to the end of its third quarter,[88] it would have likely realized that this information would have indicated a financial performance departing from any predictions, or, at least, provided the company with some uncertainty as to its financial state.

While Item 11(a) carries with it rather specific requirements, the general scheme of the federal securities laws also provides justification for utilizing the extreme departure test.[89] The court noted that one of the primary goals of the securities laws is to uphold the principles of fairness and efficiency in the market.[90] Coupled with the principles of fairness and efficiency is the notion that the market must be able to correctly align a stock's price with its "fundamental value."[91] The court noted that the need for such reliable, firm-specific information is particularly strong within the context of public offerings, where prospective investors must rely solely on

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[85] *Id.*; *see also* 15 U.S.C. § 77k (2018); LEGAL INFORMATION INSTITUTE, *supra* note 21.

[86] *Shaw*, 82 F.3d at 1205 (emphasis omitted) (quoting Instructions to Form S-3, Item 11(a)). Note that those entities filing Form S-3 prior to public offerings are of the sort not required to file more broadly available forms, such as S-1 or S-K, and are therefore not required to include in its prospectus the information required under Item 303: the disclosure of "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." *Id.* at 1205 n.9 (quoting 17 C.F.R. § 229.303(a)(3)(ii) (2018)).

[87] *Id.* at 1205 (quoting 17 C.F.R. § 229.303(a)(3)(ii)).

[88] *See id.* at 1200.

[89] *Id.* at 1207 ("Together, the Acts embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor." (alteration in original) (quoting Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 171 (1994))).

[90] *Id.*

[91] *Id.* at 1207–08 (citing Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 988–89 (1992)).

what is presented to them by the issuing entity, including stock price.[92]

In conclusion, the court noted that, although an issuing entity may have fully complied with the periodic disclosure requirements of the '33 Act, there remains the possibility that other, undisclosed facts may be material and, therefore, would have mandated disclosure.[93] While the court did reject the notion that an issuing entity must disclose certain facts in every situation in which its quarterly results may possibly be subpar and disappoint the market,[94] it held that potential investors deserve to have the most relevant and up-to-date information available to them before making an investment decision.[95] In the case of Digital Equipment Corporation, the court concluded that its third quarter results presented "more than a minor business fluctuation . . . indicating some substantial likelihood that the quarter would turn out to be an extreme departure from publicly known trends and uncertainties."[96]

B. *Stadnick v. Vivint Solar, Inc.*

Stadnick v. Vivint Solar, Inc. involved claims brought by stockholders who purchased stock of Vivint Solar, Inc. during its initial public offering (IPO), in which the plaintiffs alleged violation of Sections 11, 12(a)(2), and 15 of the '33 Act.[97] Relying on *Shaw*, the plaintiffs argued that Vivint Solar was required to disclose its interim financial statements for its third quarter, ending one day prior to its IPO, because it reflected an extreme departure from what was previously disclosed in the registration statement.[98]

1. Factual Background

Vivint Solar is a residential solar energy system company that, at the time of its IPO, was the second largest residential solar energy installer in the United States, possessing an 8% market share in 2013 and a 9% market share in 2014.[99] Vivint Solar, significantly, operates on a unique business model, which is predicated on the continued ownership of the solar energy systems that it installs.[100] This business model allows Vivint Solar to benefit from various tax credits and government incentives, which allows "[c]ustomers [to] pay no up-front costs and instead enter into twenty-year

[92] *Shaw*, 82 F.3d at 1208 (citing Kahan, *supra* note 91, at 1014–15).
[93] *Id.* at 1210.
[94] *Id.*
[95] *See id.*
[96] *Id.* at 1211.
[97] Stadnick v. Vivant Solar, Inc., 861 F.3d 31, 35 (2d Cir. 2017).
[98] *Id.* at 33.
[99] *Id.*
[100] *Id.*

leases by which they purchase solar energy in monthly payments at approximately 15% to 30% less than they would pay for utility-generated electricity."[101] Thus, Vivint Solar's monthly revenue is generated primarily by these customer payments.[102]

Due to its business structure, Vivint Solar naturally incurs major up-front costs.[103] Consequently, Vivint Solar has perpetually operated at a loss.[104] To account for this, Vivint Solar uses an accounting system called Hypothetical Liquidation at Book Value (HLBV), which means that a shareholder's ownership in the company is valued according to the balance sheet's asset valuation for the company.[105] Thus, the court noted that:

> Due to Vivint[] [Solar's] business model and the HLBV method, the allocation of income (a net loss in each quarter during the relevant period) between shareholders and [outside investors] may vary substantially from one quarter to the next depending upon (1) contributions by investors and (2) transfers of title to the funds that provided the requisite capital.[106]

Hence, when presented with the information concerning Vivint Solar's business model and accounting method, a prospective investor would have had to attempt to make sense of this complicated mix of factors to predict the success of Vivint Solar in the event that they choose to become stockholders. Indeed, this would have been an arduous task for any investor that is not an institution.

In anticipation of its IPO on October 1, 2014, Vivint Solar, in accordance with SEC regulations, issued a registration statement that included its financial statements for the preceding six quarters.[107] The Second Circuit noted that the registration statement would have indicated overarching fluctuating net losses, and even warned prospective investors of the potential impact its business and accounting models could have on the company's income allocation amongst shareholders and outside investors.[108] Despite these warnings, Vivint Solar sold 20.6 million shares of common stock during its IPO, raising a total of $300.8 million in net proceeds.[109]

Stockholder turmoil, however, began forty days later when Vivint Solar released its third quarter financial statements, indicating that outside investor-attributable net loss decreased by $28.6 million, substantially

[101] *Id.*
[102] *Id.*
[103] *Stadnick*, 861 F.3d at 33.
[104] *Id.*
[105] *Id.* at 34.
[106] *Id.*
[107] *Id.*
[108] *Id.*
[109] *Stadnick*, 861 F.3d at 34.

contributing to the decreased shareholder net income: a $40.8 million decrease, to be exact.[110] Accordingly, earnings per share fell to negative $0.45, missing the mark of analysts' projections by 143%.[111] This naturally caused a decrease in Vivint Solar's stock price, which ultimately fell by 22.5% to $11.42 per share.[112]

2. The Court's Reasoning

The court began by analyzing what the applicable test for determining the materiality of omitted interim financial information should be in the Second Circuit.[113] It concluded that it should be the total mix test, based on *DeMaria v. Andersen*, decided by the Second Circuit in 2003.[114] The following subsection analyzes the Second Circuit's decision in *DeMaria*, which adopted and set forth the total mix test.[115]

DeMaria v. Andersen concerned facts highly similar to those of *Shaw* and *Stadnick*. In *DeMaria*, plaintiffs argued that the issuing entity, ILife, failed to include in its registration statement financial information for its first quarter, which ended at the end of March, the same month in which ILife filed its registration statement with the SEC.[116] In arriving at its conclusion, the Second Circuit compared the situation in *DeMaria* to a case in which an issuing entity's disclosure consists of "both accurate and inaccurate information."[117] In essence, a registration statement that does not include interim financial information is, in fact, both accurate and inaccurate. It is accurate in the sense that it provides all of the publicly available relevant financial information that it was required to disclose under SEC regulations, but, at the same time, it is inaccurate because other information exists and is known to the issuer that would change the results of the public information disclosed in the registration statement. The Second Circuit relied on the Supreme Court's guidance in cautioning that "not every mixture with the true will neutralize the deceptive. If it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain materially so, and liability should follow."[118]

Following that line of reasoning, the Second Circuit chose to utilize the test outlined by the Supreme Court in *TSC Industries, Inc. v. Northway,*

[110] *Id.* at 34–35.
[111] *Id.* at 35.
[112] *Id.*
[113] *See id.* at 36.
[114] *Id.* (citing DeMaria v. Andersen, 318 F.3d 170 (2d Cir. 2003)).
[115] *See generally DeMaria*, 318 F.3d 170.
[116] *Id.* at 172.
[117] *Id.* at 179.
[118] *Id.* (quoting Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097 (1991)).

Inc.—the total mix test.[119] In *TSC*, however, the Court was not addressing an alleged Section 11 violation.[120] Rather, the Court was presented with an alleged violation of Section 14(a) of The Securities Exchange Act of 1934 ("'34 Act").[121] As will be discussed at the end of this section, this comparison is not particularly sound. Nonetheless, the Second Circuit applied the total mix test in *DeMaria* because the Supreme Court had used the test to determine the materiality of omitted information—although not necessarily in the same context—in *TSC*.[122]

3. Returning to the Court's Reasoning in *Stadnick*

The Second Circuit, in *Stadnick* applied the same—and, as will be argued, flawed—reasoning for applying the total mix test, stating that "*DeMaria* rests upon the classic materiality standard in the omission context[] with which [the court] and most other courts are familiar."[123] In further explaining its reasoning, the court noted that the extreme departure test applied in *Shaw* was too volatile and left too many questions open—*i.e.*, metrics, the role of the reasonable investor, etc.—in determining whether an extreme departure had taken place.[124] This argument will be discussed further in Parts IV and V.

In the case of Vivint Solar, however, the Second Circuit concluded that the company's registration statement included ample warnings for a prospective investor to conclude that such a result was possible.[125] The court was also not convinced that a reasonable investor would have considered the omission material where such reasonable investor was privy to the

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[119] *Id.* at 180. *See generally* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976).

[120] *See TSC*, 426 U.S. at 441.

[121] *Id.* The '34 Act concerns empowering the SEC with broad regulatory powers over the entirety of the securities industry. *The Laws that Govern the Securities Industry*, *supra* note 14. In providing so, the '34 Act "also empowers the SEC to require periodic reporting of information by companies with publicly traded securities." *Id.*

[122] *See TSC*, 426 U.S. at 441, 449. It is necessary to note the analogy that the Second Circuit found in *TSC*, causing it to apply the total mix test. This analogy comes, in large part, from the language of Section 14(a) of the '34 Act, which states that proxy solicitations should not be "false or misleading with respect to any material fact, or . . . omit[] to state any material fact necessary in order to make the statements therein not false or misleading." *Id.* at 443 n.6 (quoting 17 C.F.R. § 240.14a-9 (2018)). Assumedly, the Second Circuit relied on this language in applying the total mix test to the facts in *DeMaria*. *See DeMaria*, 318 F.3d at 180.

[123] Stadnick v. Vivant Solar, Inc., 861 F.3d 31, 37 (2d Cir. 2017).

[124] *Id.*

[125] *Id.* at 39 ("Vivint's registration statement contained ample warnings and disclosures that explained shareholder revenue and earning fluctuations, namely that: (1) the peculiarities of its business model and the HLBV method render the metrics identified by Stadnick less probative of Vivint's performance; (2) as a result, the income available for shareholders would likely fluctuate from quarter to quarter; and (3) Vivint anticipated its substantial operating losses to continue.").

information concerning Vivint Solar's peculiar business model and accounting method.[126]

C. *Summarizing the Split*

In choosing to apply the total mix test, the Second Circuit turned to the Supreme Court's use of the test in the context of omissions.[127] The notable difference between the cases that *DeMaria* cites to in support of its adoption of the total mix test, however, is that they are factually dissimilar to *DeMaria*, and to *Shaw* and *Stadnick*.[128] The cited cases involved violations of the '34 Act,[129] whereas *DeMaria* and *Stadnick* alleged violations of the '33 Act.[130] The position of the plaintiffs in the '34 Act cases[131] and the position of the plaintiffs in the '33 Act cases[132] are significantly different, especially when considering the sentiments underlying corporate law theory.

The very dynamic of a publicly traded corporation underlines why shareholders deserve the most relevant information when deciding on whether to invest in a particular company. Unless a shareholder owns shares in a closely-held corporation, his or her management role is slim.[133] Individually, a shareholder has an even less significant role in the corporation.[134] Notably, a shareholder has no vote on matters that are fundamental to the company's success, *i.e.*, deciding on whether to issue

126 *Id*.

127 *See id*. at 37. *See generally TSC*, 426 U.S. at 449; *DeMaria*, 318 F.3d at 178–79.

128 *DeMaria* cites the following cases in support of employing the total mix test: *TSC*, 426 U.S. 438; Press v. Quick & Reilly, Inc., 218 F.3d 121 (2d Cir. 2000); *In re* IBM Corp. Sec. Litig., 163 F.3d 102 (2d Cir. 1998). *DeMaria*, 318 F.3d at 180.

129 *See generally TSC*, 426 U.S. at 439 ("A minority stockholder in an acquired corporation brought suit against the acquiring corporation and sellers of controlling interest in the acquired corporation, charging violation of the '34 Act and rules promulgated thereunder in regard to a joint proxy statement issued by the acquiring and acquired corporations."); *Press*, 218 F.3d at 121 ("Investors brought suits alleging that broker-dealers defrauded them by failing to disclose receipt of fees from money market funds that firms selected for 'automatic sweeps' of plaintiffs' uninvested funds."); *In re* IBM Corp. Sec. Litig., 954 F. Supp. 81, 81 (S.D.N.Y. 1997) ("Stock purchasers brought class action securities fraud suit against corporation, alleging that corporation made false or misleading statements regarding its ability to continue paying quarterly dividend in present amount.").

130 *DeMaria*, 318 F.3d at 172; *Stadnick*, 861 F.3d at 35.

131 The "'34 Act cases" refers to *TSC*, *Press*, and *In re IBM*.

132 The "Section 11 cases" refers to *Shaw*, *Stadnick*, and *DeMaria*.

133 *See* WILLIAM K. SJOSTROM, JR., BUSINESS ORGANIZATIONS: A TRANSACTIONAL APPROACH 375–76 (2d ed. 2016) (noting that shareholders are only entitled to a vote on "(1) election and removal of directors, (2) amendments to the corporation's charter, (3) shareholder (as opposed to board) initiated amendments to the corporation's bylaws, (4) dissolution of the corporation, (5) a merger of the corporation, and (6) a sale of all (or substantially all) of the corporation's assets" although the board may delegate other voting powers to the shareholders in its charter or bylaws).

134 *See id*. at 378 (explaining that votes are often tied to shares and not shareholders).

more stock, deciding on whether to relocate the company's operations, deciding on whether its CEO should be replaced, and deciding on most other day-to-day operations of the company.[135] In that regard, holding a company's omissions to a lower standard with respect to shareholder disclosure claims makes sense, as it is in line with the understood, and well-established corporate management scheme. Holding omissions to a lower standard in Section 11 cases where potential investors are involved is concerning, however, because of the limited decision-making role that they would have as actual shareholders if they did, in fact, choose to purchase shares. Hence, deciding on whether to invest in a particular company is an important decision that potential investors must make, as they are essentially placing their trust in that company to make the best business decisions and to operate in an efficient and profitable manner.

There is also informs the fundamental difference in actions arising under the '33 Act and the '34 Act. The '34 Act governs after an investor has already made the decision to invest in a company.[136] The investor has already been convinced that he or she is investing in a good company and has already placed his or her trust in the company's management. At this time, after an investor has become a shareholder, fiduciary duties come into play.[137] Thus, a shareholder has recourse against director action that potentially was not in the best interest of the company.[138] These fiduciary duties, including the duty to disclose, are not present when there is no relationship between a company and its prospective investors.[139] Thus, it is even more important for a higher standard to be applied in the omission context where an issuing entity is not bound by any fiduciary duties and an investor, therefore, generally has no recourse other than through the civil liability provisions under the '33 Act, *i.e.*, Section 11.[140]

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[135] *Id.* at 376, 385; *see also* DEL. CODE ANN. tit. 8, § 141(a) (2016); MODEL BUS. CORP. ACT § 8.01(b) (AM. BAR ASS'N 2016).

[136] *See The Laws that Govern the Securities Industry*, *supra* note 14.

[137] SJOSTROM, JR., *supra* note 133, at 429 ("[C]orporate law imposes two broad fiduciary duties on directors: the duty of care and the duty of loyalty.").

[138] Although most director decisions are subject to the business judgment rule, this rule presumes that the action that potentially violated a fiduciary duty was an informed action that was done in good faith and in the honest belief that such action was, in fact, in the best interests of the company. *Id.* at 430.

[139] *See* Chiarella v. U.S., 445 U.S. 222, 228 (1980) ("[T]he duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'" (citation omitted)).

[140] *See generally* Murray L. Simpson, *Investors' Civil Remedies Under the Federal Securities Laws*, 12 DEPAUL L. REV. 71 (1962). The main advantage of bringing a Section 11 claim is that "the plaintiff can sue under this section without having to prove that the misrepresentation was addressed or intended to influence him. The cause of action runs in favor of all innocent buyers, thus eliminating the requirement of 'privity' of the parties." *Id.* at 72. Additionally, there exists no "requirement of proof that the plaintiff 'relied' on the

Accordingly, this Comment argues that the Second Circuit, first in *DeMaria* and later in *Stadnick*, incorrectly ignored the unique context in which Section 11 claims are brought as compared to the context in which the total mix test has historically been used—that being in cases arising under the '34 Act. In light of the lack of fiduciary duties present at the time of a public offering, a higher standard for evaluating the materiality of omissions must be used. As will be subsequently discussed, the extreme departure test represents that higher standard.

IV. POLICY IMPLICATIONS

This Part presents the policy implications supporting the use of the extreme departure test for omissions in the public offering context. As discussed *infra* in Part III, the lack of fiduciary duties and the importance of the public offering render it necessary to employ a higher standard in evaluating the materiality of omissions. This must be reconciled with well-established law that "[a] duty to disclose 'does not arise from the mere possession of nonpublic market information.'"[141] Thus, this Part seeks to reconcile the lack of fiduciary duties, particularly the lack of a duty to disclose, with the implementation of a higher materiality standard for omissions in the context of public offerings.

A. *The Insider Trader vs. The Institutional Trader*

The Supreme Court, in *Chiarella v. United States*, endorsed the notion of the disclose or abstain rule, which would require corporate insiders to "disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment."[142] Issuing entities may be considered insider traders, too.[143] How is it, then, that an issuing entity in

registration statement." *Id.*

[141] Roeder v. Alpha Indus., Inc., 814 F.2d 22, 26 (1st Cir. 1987) (quoting *Chiarella*, 445 U.S. at 235).

[142] *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961). The Supreme Court affirmed the derivative of the disclose or abstain rule from this case. *Chiarella*, 445 U.S. at 227–30.

[143] *See* Donna M. Nagy, *The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden*, 67 U. CIN. L. REV. 1129, 1178 (1999). Insider trading liability for companies, however, concerns a company buying or selling its own shares and repurchasing its own securities. *Id.* As such, it would not apply in the context of *Shaw* or *Stadnick*. *Id.* at 1178 n.240; *see also* McCormick v. Fund Am. Cos., Inc., 26 F.3d 869, 876 (9th Cir. 1994) ("[An issuing entity] in possession of material nonpublic information, must, like other insiders in the same situation, disclose that information to its shareholders or refrain from trading with them." (citations omitted)); Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 434–39 (7th Cir. 1987) (indicating a corporation's duty to disclose a merger to an employee cashing in his shares); Kohler v. Kohler Co., 319 F.2d 634, 638 (7th Cir. 1963) (holding that the duty to disclose material nonpublic information "appl[ies] not only to majority stockholders of corporations and corporate insiders, but equally to

possession of interim financial data that may sway potential investors' opinions of its company is not held to the same abstain or disclose rule when it is on the brink of a public offering?

Marcel Kahan argues that the disclose or abstain rule, along with other disclosure requirements, may promote the release of a greater quantity of information and more reliable information.[144] This would, in turn, facilitate a more accurate assessment of stock prices that more closely relate to the stock's fundamental value.[145] In effect, the extreme departure test is an extension of the disclose or abstain rule—it promotes essentially the same thing: either disclose where the need to do so is vague or abstain from issuing shares until that information has been timely released to the public.

While imposing the disclose or abstain rule on issuing entities is virtually impossible due to the lack of a fiduciary relationship between the issuing entity and the prospective investor,[146] the public offering market should be a level playing field, just as the corporate repurchasing market is.[147] The extreme departure test proposes a legitimate and viable solution to this issue. The test would not, in effect, pressure issuing entities to disclose all, or even a large portion of the interim information—financial or otherwise—to prospective investors. Rather, issuing entities would be forced to disclose any interim information in their possession that would present an extreme departure from any known trends or uncertainties. By definition, "extreme" signifies that the information would have to be "of [the] character or kind farthest removed from the ordinary."[148] Thus, information that would indicate a slight stray from known trends or uncertainties—*i.e.*, normal business fluctuations—would not meet this

corporations themselves"); Green v. Hamilton Int'l Corp., 437 F. Supp. 723, 728 (S.D.N.Y. 1977) ("[T]here can be no doubt that the prohibition against 'insider' trading extends to a corporation.").

144 Kahan, *supra* note 91, at 985.

145 *Id.*

146 *See generally* Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 723 (1998) ("In sum, although the insider-trading analogy suggests that there should be a duty to disclose material negative information as to interim operational results, it is unclear whether such an extension could fit within the existing structure of insider-trading law with its requirement that there be a breach of fiduciary duty (or a similar relationship of trust and confidence). Further, to recognize a fiduciary duty-based duty to disclose running from corporations to *prospective shareholders* would, in effect, produce a *duty to disclose all material information* in an offering because the nondisclosure of any material information would give rise to a claim that the company traded on material nonpublic information. Such an expansion of the duty to disclose would, to a considerable extent, nullify the specific offering-based disclosure requirements of the Securities Act of 1933.").

147 Note that the disclose or abstain rule applies to a company when it is buying or selling its own shares or participating in securities repurchasing programs. Nagy, *supra* note 143.

148 *Extreme*, DICTIONARY.COM, http://www.dictionary.com/browse/extreme (last visited Feb. 2, 2019).

standard for materiality and may be omitted without incurring liability. Only information that is significantly beyond what would be expected would rise to the "extreme departure" level. Thus, uncertainty regarding whether such information would be "of [the] character or kind farthest removed from the ordinary"[149] would arise in cases where the information is either extreme or near extreme. The disclose or abstain rule would thus be effectuated because issuing entities could face potential Section 11 liability. Normal business fluctuations naturally would not fall under this category of information, as they inherently cannot be considered extreme or even approaching extreme.[150]

B. *Who Are Reasonable Investors, Actually?*

Another important policy implication to consider is the perspective of the reasonable investor. Both the extreme departure and the total mix tests seek to determine whether an omission would be material to the reasonable investor.[151] Therefore, the better test would be able to account for the actual ability of the reasonable investor to consider the information that he or she is presented with in the prospectus and registration statement and predict the company's future performance. This Part is meant to address the question posed by the Second Circuit in *Stadnick* regarding the implementation of the extreme departure test: namely, what is "the precise role of the familiar 'objectively reasonable investor' in assessing whether a departure is extreme."[152]

In a perfect world, the total mix test would be sufficient in catering to the needs of the reasonable investor.[153] But when one looks to the reality of who the actual investor is, it is quite evident that there exists a significant disparity between the reasonable investor recognized by the law and the average investor participating in today's stock market.[154] A 2012 SEC study

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[149] *Id.*

[150] *See, e.g.*, Shaw v. Dig. Equip. Corp., 82 F.3d 1194, 1211 (1st Cir. 1996) (concluding that Digital Equipment Corporation's third quarter results presented "more than a minor business fluctuation . . . indicating some substantial likelihood that the quarter would turn out to be an extreme departure from publicly known trends and uncertainties").

[151] *See supra* Part I.

[152] Stadnick v. Vivint Solar, Inc., 861 F.3d 31, 37–38 (2d Cir. 2017).

[153] *See generally* Lin, *supra* note 5, at 467 ("In terms of cognition, the reasonable investor is generally understood to be the idealized, perfectly rational actor of neoclassical economics. The reasonable investor is presumed to operate rationally to maximize returns in the marketplace. Prior to making investment decisions, the reasonable investor is capable of reading and comprehending all the noise and signals in the marketplace that encapsulate formal disclosures, economic data, market trends, senseless speculation, and irresponsible rumors. As such, when given the requisite information, reasonable investors are able to properly price the risks and rewards of an investment.").

[154] *See* David L. Faigman, *To Have and Have Not: Assessing the Value of Social Science to the Law as Science and Policy*, 38 EMORY L.J. 1005, 1047 n.151 (1989) ("[E]conomists

found that the average American investor did not possess basic financial literacy and thus did not have the ability or the necessary knowledge to safeguard him or herself from being a victim of securities fraud.[155] Prime examples of the average investor's lack of financial literacy and ability to safeguard against fraud are the 2008 financial crisis and the dot-com bubble.[156] With the 2008 financial crisis, there is evidence that many of the defaulting borrowers who were issued subprime mortgages did not understand the borrowing terms and the complex payment structures attached to their mortgages and, in actuality, could not afford the incrementally increasing payments.[157] The case of the dot-com bubble is even more concerning, where investors jumped at the opportunity to purchase securities even remotely concerning the Internet and failed to consider other, more relevant factors, such as stock valuation.[158] In fact, research has shown that there are many other factors that determine whether a prospective investor will choose to invest in a company other than his or her rational evaluation of that company's ability to perform.[159] Tom C.W. Lin notes the following:

> Many investors, for instance, are motivated by irrelevant factors like sunlight, weather, and sleep when making investment decisions. Irrational investors also chase fads and exhibit herd mentality with their investments. Additionally, irrational investors frequently possess perilous amounts of optimism, confidence, and loss aversion that diminish their capacity to make the best investment decisions.[160]

Accordingly, courts should not be as confident as they are that the reasonable investor is actually reasonable. While there is a strong legal tradition in

who assume that people are 'rational' decisionmakers have articulated highly sophisticated models that purport to make predictions of great exactitude. In the real world, of course, people are not rational decisionmakers, and the economists' models suffer accordingly.").

155 Lin, *supra* note 5, at 469 (citing OFFICE OF INV'R EDUC. & U.S. SECURITIES & EXCH. COMMISSION, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS 15 (2012)).

156 *See id*.

157 Gerald H. Lander et al., *Subprime Mortgage Tremors: An International Issue*, 15 INT'L ADVANCES ECON. RES. 1, 4 (2009) ("Numerous borrowers say they didn't understand the loan structure and the escalating payments; in many cases, they couldn't afford them.").

158 Lin, *supra* note 5, at 469; *see also* David Kleinbard, *The $1.7 Trillion Dot.com Lesson*, CNN MONEY (Nov. 9, 2000, 5:24 PM), http://money.cnn.com/2000/11/09/technology/overview/ ("The collapse of the Internet bubble, perhaps one of the largest financial fiascoes in U.S. history, came after a three-year period, starting in January 1997, when investors would buy almost anything even vaguely associated with the Internet, regardless of valuation. Investors ignored huge current losses and were willing to pay 100 times expected earnings in fiscal 2002. They were goaded by bullish reports from sell-side securities analysts and market forecasts from IT research firms . . . .").

159 Lin, *supra* note 5, at 470.

160 *Id.*

utilizing the reasonable person standard, there exists risk in relying on the reasonable investor standard in creating judicial tests in the financial context particularly due to the market consequences that potentially may occur and, historically, have regularly occurred.

Applying the actual reasonable investor standard to facts like those in *Shaw* and *Stadnick* underscores the issues present in steadfastly applying the reasonable investor standard. At the outset, it should be noted that the term "actual reasonable investor" refers to the typical investor who, according to Lin, lacks financial literacy, is vulnerable to trends, and often acts on impulse or other external motivators.[161] As discussed above, *Shaw* presented investors with a tricky analytical situation in which predictions concerning the company's profitability and future success could have gone either way,[162] and *Stadnick*, similarly, presented investors with information that was difficult to digest and analyze.[163] Although, in theory, the information was present for prospective investors to make an accurate prediction of Vivint Solar's future success, an actual reasonable investor would not have been able to easily interpret the effects of its complex accounting methods combined with front-loaded losses. Likewise, an investor theoretically could have predicted that Digital Equipment Corporation would, once again, experience widespread and fluctuating losses, but this would have required sophisticated financial knowledge and a diligent study of the company's past-reported financial statements. This evidences the fact that the total mix of information available to investors would necessarily be assessed differently depending on the investor's level of financial sophistication. An institutional investor would have been able to see from the total mix of information available that there was a real risk of loss in either of these circumstances. An individual who trades from an online brokerage account, for example, likely would not be able to arrive at the same prediction, though, because he or she would lack the perspective to adequately analyze the total mix of information available to him or her.[164]

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161 *Id*. at 471 ("[U]nlike the reasonable investor, who lives in a simple, perfectly efficient world populated only with other perfectly informed, rational characters, the irrational investor inhabits a complicated world populated with other flawed, complex characters—the real world. Optimal investment decisions and sustained investment successes are much more difficult to model and predict in the real world. As Isaac Newton noted after suffering large losses during the South Sea Bubble of 1720, 'I can calculate the motion of heavenly bodies but not the madness of people.'" (citation omitted)).

162 Shaw v. Dig. Equip. Corp., 82 F.3d 1194, 1199–1200 (1st Cir. 1996).

163 Stadnick v. Vivint Solar, Inc., 861 F.3d 31, 33–35 (2d Cir. 2017).

164 *See* Lin, *supra* note 5, at 484 ("A diverse population of investors necessarily means that investors having asymmetrical information, varying sophistication, and disparate resources exist in the market . . . . After all, it is difficult to believe that investment banks and hedge funds, with armies of research analysts, sophisticated forecasting models, and high-speed trading platforms, are investing on the same level as the average investor who simply

Assessing the materiality of an omission should account for the disparity of investors' intelligence and sophistication along with the resources available at their disposal. The total mix test does not recognize this disparity.[165] Because the reasonable investor standard is calibrated more toward an institutional investor,[166] this standard would basically render an omission material only if an institutional investor would have viewed the omitted information as altering the total mix of their forecasted conclusions concerning the company's performance abilities. The total mix of information that an actual reasonable investor would garner from that same information is lacking due to the inability of an actual reasonable investor to fully understand, comprehend, and analyze such information.[167] Accordingly, a higher standard must be utilized to account for this disparity. The extreme departure test would be capable of doing so, ensuring that both institutional and actual reasonable investors would have the information necessary to form a complete picture of the health and potential success of an issuer in more cases than would the total mix test.[168]

V. CONCLUSION

This Comment has argued that the extreme departure test should be the standard for determining the materiality of an omission in the public offering context. While the total mix test may be appropriate in determining the materiality of other omissions or information generally, the peculiarity of the public offering context warrants the imposition of a higher materiality standard. Furthermore, the implementation of the extreme departure test would result in disclosure in more cases than the total mix test, thus establishing a quasi-disclose-or-abstain rule on issuing entities offering shares through a public offering. It would also reduce the investing

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watches *CNBC*, reads *The Wall Street Journal*, and trades with his online brokerage account.").

[165] *See generally id.* at 467.

[166] *See generally id.*

[167] Lin cites multiple studies that reveal that actual reasonable investors are incapable of "beating the market" by conducting individual research and trading. *Id.* at 486. Those studies include the following: Brad M. Barber & Terrance Odean, *Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, 55 J. FIN. 773, 785–88, (2000); Nicolas P. B. Bollen & Jeffrey A. Busse, *Short-Term Persistence in Mutual Fund Performance*, 18 REV. FIN. STUD. 569, 594–95 (2004); Ronald C. Lease et al., *The Individual Investor: Attributes and Attitudes*, 29 J. FIN. 413, 429–31 (1974); Don A. Moore et al., *Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions*, 79 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESS 95, 110–12 (1999); and Felix Salmon, *Stop Selling Bonds to Retail Investors*, 35 GEO. J. INT'L L. 837, 837 (2004).

[168] This Comment does not argue that a subjective investor test should overtake the objective reasonable investor test. It does, however, argue that courts' understanding of who constitutes a reasonable investor should change to better reflect the vast majority of investors—the actual reasonable investors. *See* Lin, *supra* note 5, at 471.

advantage of institutional investors over individual investors—an advantage that is attributable to the disparity in financial literacy, sophistication, and resources between the two groups. Additionally, it would work hand-in-hand with the pull of the market in attempting to ensure that stock valuation best matches fundamental value.

Like the total mix test, the extreme departure test still safeguards the issuing entity from the threat of overwhelming liability. The extreme departure test would only mandate disclosure when the omitted information would cause an extreme or near extreme departure from a known trend or risk. Although future case law would have to refine the terms of what would define an extreme departure, issuing entities still have clarity in their obligations. What is clear is that events classified as extreme are those "exceeding the ordinary, usual, or expected,"[169] and, thus, events that are more akin to the ordinary, usual, or expected would not rise to the level of extreme. Disclosure, then, would be necessary only in cases that depart from regular business fluctuations, yet would still be mandated more cases than under the total mix test.[170]

As indicated above, however, courts would still need to determine the metrics for determining an extreme departure.[171] Metrics for determining an extreme departure are very much dependent on the facts of each particular case. What constitutes an extreme departure for one issuing entity may not be an extreme departure for another issuing entity. Even in light of the fact-sensitive inquiry that must take place in applying the extreme departure test and the uncertainty that this may present issuing entities, the extreme departure test is flexible enough to maintain equity and fairness.

Not only will investors benefit from a higher materiality standard in the context of public offerings, but so too will the market. Stock prices are often incongruent with their fundamental value because of one or more of the following reasons: "lack of information, misassessment of information, speculative trading, and liquidity crunches."[172] The first three of these reasons are implicated by the omissions of the sort in *Shaw* and *Stadnick*. Hence, a materiality standard that induces issuing entities to disclose more information would benefit the market by ensuring that stock prices are more

[169] *Extreme*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/extreme (last visited Feb. 19, 2019).

[170] The total mix test would not warrant disclosure of an extreme departure from a known trend or risk if a reasonable investor could likely have predicted the possibility of that outcome actually occurring. The extreme departure test would warrant disclosure even when the total mix of information could have led the reasonable investor to predict that outcome.

[171] *See* Stadnick v. Vivint Solar, Inc., 861 F.3d 31, 37–38 (2d Cir. 2017) (asking "which metrics courts should look to in assessing whether such a departure has occurred" in applying the extreme departure test).

[172] Kahan, *supra* note 91, at 988.

accurate.

The focus then shifts to enforcement. The ability of courts, or even the SEC, to enforce such disclosure requirements is often doubted.[173] While courts and the SEC may undoubtedly play a role in enforcement, it is the market itself that has the ability to force compliance with the disclosures required under the extreme departure test.[174] And, indeed, the market has a reason to force compliance because of its inherent struggle to achieve equality. Therefore, the extreme departure test is courts' best attempt to implement a disclosure obligation that complements the market's disclosure demands. Together, the two may interact to decrease the disparity between an issuing entity's stock valuation and that stock's fundamental value.

In a society still recovering from the 2008 financial crisis, courts must take responsibility for strengthening the statutory safeguards in place so as to avoid the perils of the past. What the market and investors need is transparency. What issuing entities need is a stronger market with more investors. Adopting the extreme departure test for omissions in the context of public offerings has the potential to benefit all parties with proper implementation. The total mix of information points to the overwhelming benefit of the extreme departure test.

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[173] *See* Gulati, *supra* note 146, at 729 ("[C]ompanies and their lawyers will no doubt ask: (1) Does this new duty mean that when we do offerings we will have an affirmative duty to collect our intraquarterly information and examine it to see whether or not it is material? (2) What if we, for internal cost-related reasons, do not collect and evaluate information until the quarter is over? (3) Does this obligation apply only to end-of-quarter offerings? (4) Are we exempt if we time our offerings to be at the beginning of a quarter?").

[174] *See id*. at 690 ("Because the market itself disciplines firms, through the imposition of nonlegal sanctions such as reputational costs, the creation of legal sanctions is largely unnecessary to force appropriate disclosures and, in fact, is positively detrimental to a well-functioning market—witness the phenomenon of frivolous 'strike suits.'").